

# Personal Insolvency in Finland

Background report for the Finnish Economic Policy Council

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## Abstract

Household debt has increased rapidly in Finland in the 21st century, and difficulties in personal finance have become more common. According to economic literature, personal insolvency is likely to cause reduced work effort and it may also affect entrepreneurship negatively. It has been argued e.g. by the World Bank that an effective insolvency system which gives debtors a “fresh start” via debt discharge makes entrepreneurship more attractive and can also increase productivity and economic stability. However, there is only little reliable evidence on the economic effects of insolvency legislation reforms.

The purpose of this background paper is to discuss the Finnish insolvency processes, compare them to examples in other countries and identify possible bottlenecks. This report is based on earlier international literature, expert interviews and descriptive statistical analysis.

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## 1. Introduction

Concerns about increasing household indebtedness have gone to the heart of the Finnish economic debate in recent years. In Finland household debt has increased rapidly in the 21<sup>st</sup> century, and difficulties in personal finance have become more common. In June 2020, almost 400,000 Finnish citizens had payment default entries (Suomen Asiakastieto: Payment default statistics).

Over-indebtedness refers to a situation where a consumer is permanently unable to meet her financial commitments. At the macroeconomic level, over-indebtedness can have severe economic consequences. For example, whenever future expectations weaken, over-indebted households cut their consumption to be able to pay their bills. This has negative economic effects, especially during downturns, because cutting consumption can lead to a deeper and prolonged recession. (King 1994, 426.) Furthermore, wage garnishments due to foreclosures reduce debtors' incentive to participate in the labor market (Exler 2019). It has been argued by the World Bank that an effective insolvency system which gives debtors a "fresh start" via debt discharge makes entrepreneurship more attractive and can also increase productivity and economic stability (World Bank 2014, 38-39). However, there is only little reliable evidence on the economic effects of insolvency legislation reforms. (Ramsay 2017, 9-10).

Internationally, there are two alternative options for insolvent households to discharge their debts. Those procedures are bankruptcy culminating in the liquidation of the debtor's assets and debt discharge right after the bankruptcy or through a repayment period. In European countries, a repayment period is usually required before debt relief, but in the United States most insolvent households file for liquidation bankruptcy. The leniency of the debt discharge rules depends at least partly on the prevailing structure of society. The U.S. puts more emphasis on its consumer-friendly liquidation bankruptcy system due to a less developed welfare state. In contrast, in Finland, for example, the state supports households in financial difficulties in many ways and therefore the role of insolvency legislation is different.

Over-indebted people in Finland have had the possibility to apply for debt adjustment since 1993. The original Act on the Adjustment of the Debts of a Private Individual<sup>1</sup> was enacted to help people with serious debt problems following the economic depression in the early 1990s. However, the procedure has been used relatively little: around 100,000 Finns have adjusted their debts since the Act came in force (Niemi 2021, 4).

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<sup>1</sup> DAA (57/1993).

One reason for the limited use of the procedure could be the requirement that the debtor fulfills strict preconditions to be able to apply for debt adjustment.<sup>2</sup>

In Finland, an insolvent person, who does not apply for debt adjustment or be awarded it by a court, can benefit from the final expiration of the debt. This usually occurs 20 years after the debt has fallen due.<sup>3</sup> During that time the debtor may be subject to debt collection and enforcement procedures, such as wage garnishment.

Finland's debt adjustment legislation has been amended multiple times since being introduced. For example, the barriers to entry have been lowered and the time required for debt discharge has been reduced. In addition, there was a proposal for a comprehensive reform of the law in 2011, but it had a mixed reception among experts and did not lead to a reform of the law.<sup>4</sup> Since the recession in the beginning of the 1990s, there also have been several attempts to discuss the subject of personal bankruptcy and there have also been legislative proposals in this area in parliament, most recently in early May 2020<sup>5</sup>.

In this report, the classification of insolvency frameworks is first reviewed, and examples from other countries are discussed. International theoretical and empirical studies on the economic effects of insolvency frameworks are provided in Section 3. Insolvency proceedings in Finland are described and discussed in Section 4. In Section 5, the characteristics of the problem of over-indebtedness in Finland are described. Section 6 concludes.

## 2. Review of insolvency systems

This chapter introduces examples of different insolvency frameworks. Two alternative forms of debt discharge are used internationally: liquidation bankruptcy and discharge through repayment. A well-known example of liquidation bankruptcy is Chapter 7 in the U.S., which provides debt relief in exchange for the debtor giving up all her non-exempt assets. Even if recent reforms have increased payment obligations in the U.S. bankruptcy law, bankruptcy with direct discharge is still available for debtors with little payment capacity. All in all, U.S. bankruptcy legislation is the most consumer-friendly in the world. The legislation in many European countries is very strict compared to that in the U.S. The different emphasis in insolvency laws between countries is caused at least partly by country-specific attitudes towards over-indebtedness. There are also differences between countries in terms of debt discharge possibilities for entrepreneurs. The EU's

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<sup>2</sup> DAA Sections 9 and 10.

<sup>3</sup> Laki velan vanhentumisesta Section 13a (728/2020).

<sup>4</sup> Publications of the Ministry of Justice 11/2011: "Velkajärjestelyn uudistaminen". Retrieved from [https://julkaisut.valtioneuvosto.fi/bitstream/handle/10024/76292/omml\\_11\\_2011\\_mietinto\\_254\\_s.pdf?sequence=1](https://julkaisut.valtioneuvosto.fi/bitstream/handle/10024/76292/omml_11_2011_mietinto_254_s.pdf?sequence=1)

<sup>5</sup> Legislative proposal: LA 15/2020 vp.

Directive on Preventive Restructuring (Dir 2019/1023) seeks to reduce these differences in insolvency proceedings for entrepreneurs between European Union member states.

### Background to consumer insolvency laws and regulations

Over-indebtedness is a common problem in many developed countries (Heuer 2019). In recent decades, therefore, personal insolvency legislation has moved in the direction of social and consumer policy tools to tackle the potential social risks of over-indebtedness. According to Heuer (2013, 2) the Anglo-Saxon countries<sup>6</sup> were the first to make reforms in their personal bankruptcy laws to meet the modern challenges of consumer over-indebtedness. In the 1990s also several European countries added debt discharge procedures to their legislation. In particular, the banking crisis in the Nordic countries in the same decade and German reunification accelerated this process. Insolvency legislation in these countries differs from that in Anglo-Saxon countries; instead of quick debt discharge, debts are usually discharged following a repayment period. (Hiilamo 2018, 37-38.)

There are two alternative forms of personal debt relief systems in Europe and the U.S.: liquidation bankruptcy and discharge through repayment. In the former, the debtor's non-exempt assets are liquidated to pay the debts and then the remainder of the unsecured debts are discharged. In the latter, the debtor earns debt discharge after she has completed a payment plan and paid a proportion of the debts. In the United States, Canada and the United Kingdom, insolvency legislation for private individuals includes both alternatives, but in Europe the repayment model dominates.

The overall rules on insolvency systems are stricter in Europe than in the United States. As well as wage garnishments, the rules in Europe differ and are stricter than in the U.S., for example, to the amount of debt that can be discharged and the leniency of exemption rules, that is, rules on what income and property the debtor may keep through the debt adjustment. (Gerhardt 2009.) Different emphasis in insolvency laws between different countries is caused at least partly by country-specific attitudes towards over-indebtedness. In the United States, the ability to make a swift comeback to the credit market is emphasized and the main purpose of bankruptcy laws is to serve the credit markets. Hence, over-indebtedness is seen as a market failure. In Europe, national legislation views over-indebtedness as a consequence of, for example, economic recessions, unemployment or personal misfortune. In addition, fraud and reckless behavior are punished more severely in European countries compared to the United States. Thus, over-indebtedness is seen more as a social and moral problem than a market failure. (Niemi-Kiesiläinen 1999; 2003.)

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<sup>6</sup> The United Kingdom, Australia, New Zealand, Canada and the United States.

White (2007, 191) suggests comparing different bankruptcy policies through seven parameters which summarize the key dimensions of such legislation. Those parameters are 1) the amount of debt discharged, 2) asset exemption, 3) income exemption, 4) the fraction of debtors' future income above the exemption that must be used for repayment, 5) the length of the repayment obligation, 6) bankruptcy costs and 7) bankruptcy punishment. According to Liu & Rosenberg (2013), an insolvency framework can be judged by the time required, the costs of the procedure and the recovery rates of insolvencies.

There are some common features to almost all national insolvency legislation. For example, in the debt adjustment process, the payment capacity of the debtor is determined. Debtors can be divided into two groups: One group consists of those who do not have income or assets, or their earnings and assets are so low that they are exempt from collection (no income, no assets; so-called NINA debtors). The second group consists of debtors who have capacity to pay back at least part of their debts. Creditors are also divided into two groups: secured creditors and unsecured creditors. The former group consists of those creditors whose claims are secured by collateral in the debtor's property. Other creditors are so-called unsecured creditors and they do not have any security for their claims in the debtor's property. Bankruptcy concerns mainly unsecured debts. (Heuer 2013, 4.) The debt settlement, in turn, can also affect secured creditors if the family home is used as collateral (Hiilamo 2018, 38).

A debt adjustment process is usually initiated following an application by the debtor, but in some countries, creditors can apply for a process that leads to debt adjustment. For example, the U.S. bankruptcy leads to discharge of debt also when it has been initiated by a creditor. The applicant must meet certain personal and financial preconditions<sup>7</sup> to be approved for debt adjustment. The procedure may also include access screening, in which the debtor's personal and economic situation is examined. While the application is being processed, a stay of enforcement actions might come into effect. In some insolvency systems, debt discharge might be conditional on educational or behavioral obligations on the debtor, for example the debtor should participate financial literacy education, seek employment or abstain from taking on new debt. Some countries place economic, political or civil restrictions on the debtor. These can include a ban on corporate management positions or leaving the country. Normally a debt adjustment procedure ends in full or partial debt discharge and it can be automatic, discretionary or conditional. (Heuer 2013, 4-5.)

#### Heuer's classification

Heuer (2013) classifies insolvency frameworks in 15 developed countries into four groups. The classification is based on three questions regarding a "fresh start" policy which each consumer bankruptcy system must deal with. The first question is about the debtor and her eligibility for a fresh start. The second question

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<sup>7</sup> E.g. debt level, value of assets, number of creditors and duration of the debt problem.

concerns what can be discharged and the extent of a fresh start. The third question deals with the time frame related to a fresh start: for example, when the debt discharge is implemented and how long the duration of bankruptcy is. Heuer also provides the following characteristics for each category:

- *The market model* (U.S. and Canada) provides a quick debt discharge for the debtor and ensures re-entry to the credit market. However, many claims from non-commercial or reluctant creditors are often excluded. This model is based on a description of bankruptcy as a reallocation of risk and the cost of default from debtors to creditors and aims at increasing market efficiency. Heuer (2013) points out that educational and behavioral requirements for debtors have been introduced in these countries recently and these new requirements have weakened the approach.
- *The restrictions model* (England, Scotland, Australia and New Zealand) has many similarities to the market model and recently these countries have reformed their debt relief rules in the direction of the market model. For example, the duration of the bankruptcy is short - from one to three years. However, these systems include economic, political and civil restrictions on debtors which do not conform to the market model. Hence, these systems indicate a mechanism of public protection.
- *The liability model* (Germany and Austria) emphasizes the individual responsibility of debtors to repay their debts and thus long payment periods are typical for these models. In Germany the payment period is six years and in Austria seven years. In addition, these systems require several educational and behavioral commitments by the debtor. They share the same view as the market model about over-indebtedness being an economic phenomenon but highlight the responsibility of the debtor, in contrast to the market model, which takes the view that creditors are responsible for offering credit. The aim of these models is to serve creditors by increasing the amount of debt paid back.
- *The mercy model* (Finland, Denmark, Norway, Sweden, France and Belgium). In these insolvency systems the needs and abilities of debtors are central and debt settlement officials have the power to shape the duration and outcome of the debt relief process. For example, in Scandinavian systems there are strict screenings of applicants and in France there are many different possible procedures for receiving debt relief. This model is called the mercy model because in these systems debtors are at the mercy of bankruptcy officials.

Heuer's (2013) analysis of bankruptcy models is based on eight issues<sup>8</sup> which are common to bankruptcy systems and are closely related to the questions mentioned above. He measured these issues by eight indices

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<sup>8</sup> (1) the prevention of bankruptcy misuse, (2) educational and behavioral obligations for debtors, (3) debtor disqualifications and restrictions, (4) debtor protection, (5) support for NINA debtors, (7) the duration of bankruptcy, and (8) the scope of discretionary powers for bankruptcy officials (Heuer 2013, 9).

and 41 indicators<sup>9</sup>. Five of these 41 indicators did not vary between the countries studied and can thus be seen as a common core of consumer bankruptcy procedures. These features are: stay of individual debt enforcement, requirement of procedural honesty, liquidation of the debtor's assets excluding non-exempt assets, payment period for those debtors who have the ability to pay, and discharge of contractual debts.

### International examples of consumer bankruptcy regulation

The first European country to introduce judicial debt adjustment procedure was Denmark in the 1980s. Other Nordic countries introduced debt adjustment laws in the beginning of 1990s. In Norway, the Debt Settlement Act came into force in 1993. It was enacted after the debt crisis to help people with heavy debt burdens. The main eligibility criterion for access to a debt settlement is that the debtor is permanently unable to repay her debts. Debt settlement normally takes five years and during that time the debtor must commit herself to a thrifty life. In debt settlement, the debtor can only keep an apportioned part of her income to cover basic needs and the rest is used to repay the debts. After five years, the debtor will be released from all remaining debt. (Poppe 2008.)

In Germany, bankruptcy legislation is very strict for debtors. Insolvent individuals must give up all their liquid assets and in addition they are subject to significant wage garnishment during the bankruptcy period. In practice, 70% of annual net income in excess of EUR 12,600 is garnished and all income in excess of EUR 38,500 is fully garnished. After six years, the remaining debts of a bankrupt individual are discharged, and the household is released from bankruptcy. (Exler 2019, 2.) Characteristically, the debtor is under monitoring by the creditors and by the enforcement authority during the payment plan.

In the U.S., bankruptcy regulation is more consumer-friendly than in any other country. Consumers who declare bankruptcy can choose between liquidation of outstanding debts (Chapter 7) and repaying debts on an installment plan over several years (Chapter 13). However, the law reform of 2005<sup>10</sup> prevents households with above-median income from filing for Chapter 7 bankruptcy. (Gordon 2015.) According to Exler and Tertilt (2020, 6), approximately 70% of debtors file under Chapter 7 liquidation. Filing under Chapter 7 is followed by liquidation of all of a debtor's non-exempt assets in exchange for discharge of remaining unsecured debts. In contrast, Chapter 13 filers can keep all their assets but must use their future income to repay their debts. Usually this takes three to five years, and after the payment plan is completed the debtor earns discharge of her remaining debt. (Gross et al. 2019, 5-6.) There are significant variations in the exemption levels, that is the assets the debtor may keep notwithstanding bankruptcy, between U.S. states (Gropp et al. 1997).

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<sup>9</sup> See Heuer (2013) for details.

<sup>10</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, BAPCPA.



## Treatment of failed entrepreneurs

McGowan and Andrews (2018) study differences in insolvency regimes between countries. Their comparison is based on quantitative indicators constructed from countries' responses to an OECD policy questionnaire. They compare the personal costs to failed entrepreneurs between countries. They show that there are significant between-country differences in discharge possibilities. In most of the countries in their sample, asset exemptions are limited to modest personal items and working equipment. According to their study, the lowest personal costs to failed entrepreneurs are in Canada, Turkey and the United States.

The Finnish Ministry of Justice has published an international comparison of the possibilities for entrepreneurs to make a fresh start in certain European Union member states and in the U.S. (Heinonen 2018). The report notes that significant reforms have been made to insolvency proceedings and debt relief in many of the countries in the 21<sup>st</sup> century. There are no liquidation procedures in any of the countries in which a private debtor can be relieved of all her debts. Instead, debt relief through liquidation is restricted to certain types of debt, for example in the U.S. and England. For private debtors or entrepreneurs, debt relief usually takes the form of a procedure based on a payment plan. The duration of the payment plan or other debt relief process varies from two to six years in the countries studied. Typically, a debtor whose insolvency is caused by business debt is relieved from debt liabilities via a payment plan of three or five years. It is noted in the report that in Sweden and Denmark there is a particular debt adjustment procedure intended specifically for entrepreneurs. (Heinonen 2018.)

In 2019, the EU adopted a new Directive<sup>11</sup>, the Directive on Preventive Restructuring to facilitate business restructuring in the face of insolvency. For the first time, the directive sets insolvency regulation in the context of the regulation of the single market and envisions an important role for insolvency law in promoting the efficiency of the single market.

The directive includes an opportunity for a "fresh start" for entrepreneurs through discharge of pre-insolvency debt. The purpose is that an honest, insolvent or over-indebted entrepreneur can be relieved fully of her debts over a moderate time period. Under the directive, member states must set up a procedure in which an insolvent debtor can obtain discharge either immediately or after a repayment period not exceeding three years.

## Main findings

In general, there are two alternative procedures for a private person to be relieved from insolvency: liquidation bankruptcy and debt discharge through repayment. Different countries have different ways of

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<sup>11</sup> EU (2019/1023).

applying these procedures. In particular, differences in national legislation are related to the duration, extent and costs of the procedure. However, there are also some similarities between national processes such as a requirement of procedural honesty, liquidation of the debtor's assets excluding non-exempt assets and a payment period for those debtors who have the ability to pay. According to Heuer's (2013) classification, the insolvency systems of 15 developed countries all fall into one of four categories depending on the characteristics of the particular system. These categories are the market model, the restrictions model, the liability model and the mercy model. There are also differences between countries in terms of the treatment of insolvent entrepreneurs. At least in Sweden and Denmark, there are particular debt adjustment procedures intended specifically for entrepreneurs. The new EU Directive on Preventive Restructuring seeks to harmonize insolvency proceedings for entrepreneurs in the member states.

### 3. Economic research

The economic literature on insolvency frameworks is discussed in this chapter. The research has mostly been theoretical in nature and has mainly focused on models depicting a "fresh start" bankruptcy system without claims on future labor income<sup>12</sup>. The motivation in a number of studies has been to determine the optimal insolvency policy. In particular, the employment and welfare effects of different insolvency systems have been the focus of these studies. The findings are controversial, and very sensitive to modeling options. Nor can results obtained in empirical studies using data from a specific country be used directly in other countries. This is because the prevailing environment must be taken into account, e.g. national legislation as a whole and the social security system, when evaluating the insolvency framework.

#### Welfare implications of personal bankruptcy

Earlier literature offers a trade-off between two opposing forces for policymakers when evaluating the bankruptcy rules and the opportunity for a "fresh start". On the one hand, personal bankruptcy and a fresh start provide consumption insurance to households suffering from bad luck and misfortunes<sup>13</sup>. A swift and easy bankruptcy means more comprehensive insurance, but it comes at a cost. That is, according to general equilibrium analysis, more lenient bankruptcy systems have been connected to higher borrowing costs, which makes intertemporal consumption smoothing more difficult. This highlights the importance of evaluating the quantitative costs of credit market distortions and the extent of bad luck when assessing a bankruptcy system. (Livshits et al. 2007; Exler & Tertilt 2020.)

Livshits et al. (2007) analyze the impact of different consumer bankruptcy rules on unsecured debt in a general equilibrium setting. They introduce two different bankruptcy systems in their model: the fresh start

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<sup>12</sup> Mostly bankruptcy under Chapter 7 in the U.S.

<sup>13</sup> E.g. divorce, unemployment or illness.

policy captures the key feature of the U.S. Chapter 7 and allows full debt discharge. Second, the no fresh start policy captures the idea of life-long liability for debt without the possibility of debt discharge in this regime. They also consider different types of uncertainties in their model: income uncertainty, which refers to variations in the earnings of households over time, and expense uncertainty, which refers to expense shocks such as uninsured medical bills or divorce. They find that expense shocks in particular play a significant role in the evaluation of a bankruptcy system. By introducing expense shocks into their model, they find that the fresh start option improves welfare compared to a no fresh start policy when the model is calibrated to the U.S. economy. They note that their results are sensitive to both the nature and extent of uncertainty as well as the life-cycle profile of earnings and family size.

Livshits et al. (2007) also find that the more persistent the income shocks are, the more attractive the fresh start policy is. This is due to the fact that transitory income shocks can be more easily smoothed across time by borrowing and saving. The consumption profile is also steeper under the fresh start policy, while the variance of consumption is smaller for most age groups compared to a no fresh start system. This is because a fresh start option makes borrowing constraints tighter for the average borrower. In contrast, the ability to smooth income across states is improved under the fresh start option. This suggests that the fresh start facilitates insurance across states, while no fresh start makes life-cycle smoothing easier. As a result, flatter income profiles over the life-cycle make fresh start more attractive than a no fresh start policy.

In an empirical study, Gross et al. (2019) show that bankruptcy reform in the U.S. in 2005 was associated with interest rate declines in unsecured credit markets. This reform made bankruptcy less attractive, reducing the bankruptcy risk faced by financial institutions. Their results highlight the trade-off that policy makers must deal with when designing a bankruptcy system. Marginal filers<sup>14</sup> may benefit significantly from a more generous bankruptcy system because they can be allowed to discharge their debts instead of repaying, but these benefits come at the cost of higher interest rates for other households.

Using an incomplete market model, Exler and Tertilt (2020) view that the option of a swift debt discharge is a useful part of current U.S. bankruptcy legislation. However, they point out that this conclusion is quite sensitive to the details of the environment. They highlight the importance of the type and amount of risk that households face when evaluating the welfare gains of any specific bankruptcy law, which is in accordance with the results of Livshits et al. (2007). However, Exler and Tertilt (2020) note that in other countries with lower idiosyncratic risk<sup>15</sup>, stricter bankruptcy law is justified.

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<sup>14</sup> Those consumers who were deterred from filing under chapter 7 by BAPCPA.

<sup>15</sup> An event that could specifically affect a certain individual but not the whole population.

Exler (2019) studies an optimal bankruptcy regime in Germany using a limited commitment model. He finds that if the garnishment rate is lowered by over 26 % and the exemption level is reduced to EUR 50 and at the same time the garnishment period is extended from 6 to 10 years, it would improve aggregate welfare by 3.3% and increase the labor supply. Lower marginal rates reduce the substitution effect and a prolonged garnishment period increases the income effect. These two effects increase the labor supply even when compared to a no garnishment alternative. This reform would also reduce interest rates and improve credit access, increasing total credit in the economy. Exler also observes that in his model, total removal of the liability for payment (as in the U.S. Chapter 7) reduces welfare in Germany. His results challenge the conversation about the alleviation of insolvency systems in Europe.

Strict bankruptcy legislation reduces moral hazard among borrowers and can improve credit access. However, it also increases moral hazard on the part of lenders because more strict legislation encourages lenders to offer unsustainable credit. White (2007) notes that problems caused by over-indebtedness cannot be solved simply by making bankruptcy legislation less consumer friendly. She rather suggests combining strict bankruptcy legislation with truth-in-lending rules which guarantee that creditors can face losses when they supply too much credit or charge excessively high interest rates or costs.

### Labor supply and bankruptcy

Wang and White (2000) point out that when evaluating bankruptcy reforms, it is important to determine how reforms affect working hours for consumers who file. Reforms are not designed to incentivize consumers who file for bankruptcy to resign from their jobs or to reduce their work effort. In the U.S., one of the main arguments in favor of the “fresh start” under Chapter 7 bankruptcy is that it creates an incentive to work for individuals with a heavy debt burden (Chen & Zhao 2017). Nevertheless, in literature the employment effects of different insolvency proceedings are still controversial (see e.g. Chen & Zhao, Han & Li 2004/2007).

Dobbie and Song (2015) study the outcomes of debt relief for debtors. The study is based on U.S. data and they study outcomes for individuals who filed bankruptcy under Chapter 13. Their study provides strong evidence of labor supply reactions. They show significant negative effects of income seizure on future annual gross earnings. The authors analyze households in the U.S. that face high effective marginal tax rates due to wage garnishment by their creditors. Households that file for bankruptcy and are thus shielded from garnishments are found to have significantly higher gross wages. This is in accordance with Rea (1984), who points out that wage garnishments work as an income tax. In extreme cases, if the garnishment is large enough, a debtor may quit her job because the combination of welfare benefits and full leisure is preferable to the other options.

Chen and Zhao (2017) provide quantitative evidence on the labor supply effects of the U.S. bankruptcy code in a structural model. They find that Chapter 7 filers increase their labor supply by 12.3% on average. In

contrast, those filers who are compelled to file under Chapter 13 increase their labor supply only by 0.3%. Their results thus support the view that a swift fresh start improves work incentives.

Han and Li (2007), in contrast, do not find that filing for bankruptcy has any positive impact on households' annual hours worked. They study the employment effects of bankruptcy law in the U.S. using data from the Panel Study of Income Dynamics<sup>16</sup>. They estimate the effects in a standard treatment effect model using the instrumental variable approach. Their findings suggest that the fresh start argument should not be taken for granted when evaluating the welfare consequences of personal bankruptcy law or when proposing new changes. Dobbie and Song (2015) point out that most comparisons (including that of Han and Li (2007)) are biased due to selection and endogeneity problems. Bankruptcy filers are likely to have had worse outcomes even before filing and this is likely to bias cross-sectional comparisons.

### Leniency of bankruptcy law and entrepreneurial activity

According to McGowan and Andrews (2018), between-country evidence suggests that a long period before debt discharge can discourage entrepreneurship because it increases the costs of starting risky businesses. In an empirical study, Burchell and Hughes (2006) use data from the Eurobarometer survey and find that favorable attitudes towards a second chance for individuals who have previously failed in business are positively correlated to GDP growth. Eberhart et al. (2017) utilize a quasi-natural experiment in Japan and find that lower barriers to exit attract entrepreneurs who are most likely to succeed, i.e. individuals with higher human capital. Fan and White (2003) show that bankruptcy with higher exemption levels provides partial wealth insurance, which makes potential entrepreneurs who are risk-averse more likely to choose self-employment. They also confirm this with empirical tests using U.S. data.

### Main findings

Previous economic studies on personal insolvency cannot be easily compared. This is because the results are obtained by different methods, models and data. In addition, the results are sensitive to prevailing conditions, and thus cannot be generalized to apply in other countries. However, the most important finding is that the insurance role of bankruptcy law should be taken into consideration when evaluating possible law reforms. The extent of insolvency legislation must be integrated into the prevailing environment. Positive employment effects might also occur after debt relief, as suggested theoretically, but the results obtained in empirical studies are still controversial and more research is needed in this area. In addition, empirical studies suggest that lenient bankruptcy legislation may improve entrepreneurship. On the other hand, lenient

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<sup>16</sup> Filers under Chapter 7 and Chapter 13 are not separated in their data but their main results do not change even if Chapter 13 filers are excluded from the sample.

bankruptcy legislation is connected to tighter borrowing constraints and higher interest rates, which might impede entrepreneurial activity and reduce overall welfare.

## 4. Insolvency in Finland

In this chapter, personal insolvency issues in Finland are considered and information regarding the treatment of over-indebted entrepreneurs in Finland is offered via expert interviews. In Finland, creditors generally recover their overdue debts first with the help of private debt collection agencies and, when this is unsuccessful, through debt enforcement which allows enforcement authorities for example to garnish the debtor's income. In Finland, debt adjustment for private individuals is the insolvency procedure for a natural person to be relieved from insolvency. Before applying for debt adjustment, a debtor must attempt a voluntary settlement to solve her financial difficulties.

The very first option when a debtor is unable to pay her debts when they fall due is to negotiate with the creditors about the terms of payment and try to come to an agreement. The other option is debt consolidation with help from the Guarantee Foundation or by applying for social loans from the municipality. If, in spite of voluntary action a debtor drifts into insolvency, she can apply for debt adjustment and receive a confirmed payment plan from the district court. In Finland, private entrepreneurs are allowed to adjust their business debts alongside private debts in a debt adjustment process and to continue business activity.

### Debt collection

In Finland, most companies rely on private debt collection agencies when their debtors are in default. The actions for debt collection are regulated in law. The debt collection agencies use letters, phone calls and increasingly electronic communication in their attempts to induce the debtor to pay. They also file the case in court to get a judgement.

The state enforcement authorities are the ones who have the competence to force a payment through seizure and sale of assets and wage garnishment. This kind of enforcement requires a judgement on the debt, even though regarding some debts to the public, such as taxes and fees for many public services, the decision of the public body is a valid entitlement for enforcement. The purpose of debt enforcement is to ensure payment of the creditor's claims. During debt enforcement, the debtor's income may be garnished and assets distrained until the debt in enforcement is fully paid or the 15-year limit for the enforcement of a judgement runs out. In principle all types of income and assets are acceptable for enforcement. However, conventional

household effects are not distrained. Usually, enforcement is directed at the debtor's wages, salary, pension or business income. Personal property or real property can also be distrained.<sup>17</sup>

Empirical studies have shown that wage garnishments can negatively affect a debtor's incentives to work, as noted in chapter 3 of this report. For that reason, an unemployed debtor in Finland may be allowed to postpone enforcement actions for four months if she finds employment.<sup>18</sup> The maximum amount which can be garnished is also limited according to Sections 48 and 49 of the Enforcement Code. In general, one third of a debtor's net income can be garnished. There is also a protected minimum portion<sup>19</sup> to protect the livelihood of the debtor and her family, which cannot be garnished in any situation.<sup>20</sup>

Enforcement actions end when debts in enforcement are fully paid or the debts expire. The duration of the enforceability of an enforcement order depends on the nature of the debt. For example, debts subject to a court judgement expire 15 years after the enforcement order is issued, but in 20 years if the creditor is a natural person.<sup>21</sup> The regulation of expiration of debt was amended in the beginning of 2015 in such a way that all debts permanently expire after a statutory time despite the period of limitation for enforcement. This occurs in 20 or 25 years after the expiration date of the debt and this expiration cannot be interrupted.<sup>22</sup>

Enforcement actions are also precluded if a debtor is admitted to debt adjustment. Paying debts through debt enforcement proves the debtor's willingness to pay her debts and this can facilitate access to debt adjustment later.

## Social loans

The purpose of social lending is to prevent economic exclusion and over-indebtedness.<sup>23</sup> By law, a social loan can be granted to an individual who has no other way of accessing a loan on equitable terms because of low income and limited means but who has the ability to repay the loan.<sup>24</sup> The law states that municipalities can provide social lending within the scope of municipal social services, but it is discretionary.<sup>25</sup> Particularly cities have opted to set up a social loan program.

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<sup>17</sup> Enforcement: Dstraint and garnishment. Retrieved July 16, 2020, from <https://oikeus.fi/ulosotto/en/index/velallisenautosotossa/ulosmittaus.html>

<sup>18</sup> Enforcement Code (EC) 51a § (705/2007).

<sup>19</sup> The protected portion is EUR 22.63 per day in 2020 plus EUR 8.12 per day per dependent person.

<sup>20</sup> Enforcement: Attachment of salary. Retrieved July 16, 2020, from <https://oikeus.fi/ulosotto/en/index/velallisenautosotossa/palkanulosmittaus.html>

<sup>21</sup> EC 24 § (705/2007).

<sup>22</sup> Amendment (1125/2014).

<sup>23</sup> Laki sosiaalisesta luototuksesta (LSL) 1 § (1133/2002).

<sup>24</sup> LSL 4 §.

<sup>25</sup> LSL 2 §.

In Finland, around 30 municipalities provide social loans to their residents and around 44% of Finnish citizens have the possibility to apply for such loans.<sup>26</sup> A social loan can be granted for debt consolidation, for example. A general obstacle to accessing a loan is a lack of available funds. It is furthermore required that a social loan enables the debtor to restructure all her debts and loans.<sup>27</sup> The interest rate on a social loan can be at most the reference rate defined in Section 12 of the Interest Act.<sup>28</sup>

Social lending was in active use in 30 municipalities in 2019. In that year, municipal authorities granted a total of EUR 3.6 million of social loans, almost half of that in Helsinki. Altogether, 533 individuals received social loans in 2019. In most cases loans were granted for consumer debt, enforcement debt or for managing daily household expenses. The average loan per person was roughly EUR 6500 in 2019. For comparison, in 2016 the average loan in 2019 prices was EUR 6000.

The repayment capacity condition excludes those on very low incomes from assistance of this type. The law also states that an applicant's right to receive income support must be investigated before a social loan can be granted.<sup>29</sup> Two thirds of those who received social loans in 2019 were employed and 30% were pensioners. 47 people received a loan despite being unemployed or students.<sup>30</sup>

### The Finnish debt adjustment procedure

In Finland, household insolvencies are regulated by the Act on the Adjustment of the Debts of a Private Individual<sup>31</sup>, which came into force in 1993. The DAA makes adjustment of debts possible for debtors who are unable to pay back their debts. Its purpose is to improve the financial situation of an insolvent private individual and at the same time to guarantee creditors as much of their claims as possible. The DAA also has social political and economic objectives. For example, the aim of the adjustment of debts is to mitigate the social problems caused by insolvency and to reduce social assistance payments. In addition, release from debts should enable a debtor to seek employment or to start a business. Insolvency legislation can also help to prevent the negative consequences of debt problems (e.g. black market). (Valkama 2011, 2-4.)

Debt adjustment should be the last option for solving over-indebtedness and a debtor applying for debt adjustment must meet the criteria listed in the DAA. The main criterion for qualifying for debt adjustment is

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<sup>26</sup> MSAH: Sosiaalinen luototus. Retrieved July 14, 2020, from <https://stm.fi/toimeentulo/sosiaalinen-luototus>

<sup>27</sup> MSAH: A guide on Social Lending 2003. Retrieved July 14, 2020, from [http://julkaisut.valtioneuvosto.fi/bitstream/handle/10024/70029/oppaita03\\_6.pdf?sequence=1&isAllowed=y](http://julkaisut.valtioneuvosto.fi/bitstream/handle/10024/70029/oppaita03_6.pdf?sequence=1&isAllowed=y)

<sup>28</sup> The Interest Act 12 § (633/1982) and LSL 6 §.

<sup>29</sup> LSL 10 §.

<sup>30</sup> THL: "Sosiaalinen Luototus 2019 – Kuntakyselyn osaraportti".

[http://www.julkari.fi/bitstream/handle/10024/140129/Sosiaalinen\\_luototus\\_kuntakyselyn\\_osaraportti\\_21\\_2020.pdf?sequence=5&isAllowed=y](http://www.julkari.fi/bitstream/handle/10024/140129/Sosiaalinen_luototus_kuntakyselyn_osaraportti_21_2020.pdf?sequence=5&isAllowed=y)

<sup>31</sup> Act on the Adjustment of the Debts of a Private Individual (DAA, 57/1993).



that the debtor is permanently unable to repay her debts<sup>32</sup>. There is also a list of impediments to obtaining debt adjustment: e.g. if the debtor's inability to pay is temporary, the debtor has deliberately weakened her financial position, or if there is an earlier confirmed payment plan.<sup>33</sup> A debtor who has an impediment can nonetheless obtain debt adjustment if a court considers there to be compelling reasons.<sup>34</sup>

The debt adjustment procedure begins when a debtor applies for debt adjustment from the district court. A debtor can get help with the application from financial and debt counsellors. Once she has submitted an application, she must commit to the rules of debt adjustment. For example, money can only be spent on essential expenses and debt payments. It is also forbidden to move to a more expensive residence or resign from one's current job. In addition, the debtor must avoid accumulating new debt.<sup>35</sup>

All debts that have been accumulated before the beginning of the procedure will be adjusted (Valkama 2011). The debtor is obligated to use all income that exceeds her necessary living expenses and child support liability to cover her debts. She must also use all her assets which do not constitute basic necessities to pay her debts.<sup>36</sup> In debt adjustment 1) the terms of payment can be changed; 2) it can be decided that the debtor does not pay any credit costs until the stock of the debt has been fully paid back; 3) the payment obligations of the credit cost in the remaining credit period can be reduced; 4) the unpaid share of the debt can be reduced; 5) the obligation to pay the debt can be removed. Debt adjustment can also include full or partial payment of the debt with a new loan taken out for that purpose.<sup>37</sup>

After receiving the application, the district court examines it and may hear some of the creditors (Valkama 2011). If the debtor receives a positive decision on the access to the procedure, she is no longer allowed to pay anything other than interest on secured debt and child support payments, until the payment plan is confirmed.<sup>38</sup> A decision to start proceedings also precludes creditors from debt enforcement actions and other debt collection is also prohibited.<sup>39</sup> If the debtor's wages were garnished before opening the procedure, the garnishment continues but the debt enforcement authority keeps the money.

If the district court approves an application for debt adjustment, the next step is to create a payment plan for the debtor. The purpose of the payment plan is that the debts will be paid but at the same time it ensures the debtor a reasonable standard of living. (Valkama 2011.) Debtors can enclose a payment plan proposal

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<sup>32</sup> DAA Section 9.

<sup>33</sup> See DAA Section 10 for full list of impediments.

<sup>34</sup> DAA Section 10a.

<sup>35</sup> HE (180/1996) vp, s. 46.

<sup>36</sup> DAA Section 5.

<sup>37</sup> DAA Section 25.

<sup>38</sup> DAA Section 12.

<sup>39</sup> DAA Section 17.

with their application.<sup>40</sup> If creditors have approved the plan in advance, the district court confirms it. Otherwise the district court will request approval of the payment plan from the creditors but their opinion is not binding.<sup>41</sup>

The Ministry of Justice appointed a committee to look into a comprehensive reform of debt adjustment legislation in 2011. The committee's report states (based on Kirsti Rissanen's report for the MEAE<sup>42</sup>) that most payment plans are made by administrators appointed by a court. In practice, an administrator is appointed whenever an application does not include a payment plan proposal even though under Section 64 of the DAA an administrator may be appointed only when necessary. Financial and debt counseling services were transferred from the municipalities to the state legal aid office in the beginning of 2019. At the same time, it was stressed that the preparation of payment plan proposals is the job of debt counselors. This may have reduced the use of administrators in setting up payment plans.

The duration of payment plans was reduced to three years from the original five years in 2010.<sup>43</sup> Now a payment plan can be prolonged to five years if it has been confirmed despite impediments. Prolonged payment plans also apply to NINA (no income, no asset) debtors, but in cases of permanent inability to pay the payment period may be shorter. The duration of a payment plan can be a maximum of 10 years for unsecured debt if the debtor keeps her residence but there is no limit for secured debt. A payment plan can be prolonged at most by four months to pay the administrator's fee. After a payment plan is completed remaining debts are discharged.<sup>44</sup>

Under the DAA a debtor must pay her creditors part of any additional income or funds she receives during the payment plan period.<sup>45</sup> This is called an additional payment obligation. The debt adjustment ends once the debtor has made all the payments due under the payment plan and any payments arising from an additional payment obligation. For example, if the debtor receives a non-recurring payment (all non-recurring payments are added together) in excess of EUR 1000, she must pay the excess to the creditors. Also, a rise in income will trigger an additional payment obligation if the debtor's net income increases by EUR 2000 during the calendar year compared to the income in the debtor's payment plan. In that case the debtor must pay the creditors half of the income exceeding an increase of EUR 2000 a year.<sup>46</sup>

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<sup>40</sup> DAA Section 51.

<sup>41</sup> DAA Section 52a.

<sup>42</sup> See "Talous- ja velkaneuvonnan arviointi". Report by Kirsti Rissanen (TEM 8/2009).

<sup>43</sup> HE (52/2010) vp.

<sup>44</sup> DAA Sections 29 and 30.

<sup>45</sup> DAA Section 35a.

<sup>46</sup> Financial and debt counselling: Additional payment obligation. Retrieved 19.8.2020 from [https://oikeus.fi/oikeusapu/en/index/financial\\_and\\_debt\\_counselling/velkajarjestely/lisasuoritusvelvollisuus.html](https://oikeus.fi/oikeusapu/en/index/financial_and_debt_counselling/velkajarjestely/lisasuoritusvelvollisuus.html)

In 2015 the Act on the Adjustment of the Debts of a Private Individual was extended to entrepreneurs.<sup>47</sup> However, most applicants are still private individuals: for example, according to Statistics Finland there were a total of 3436 debt adjustment applications in 2019<sup>48</sup> but according to the Finnish insolvency register only 13 entrepreneurs applied for debt adjustment that year<sup>49</sup>. In the 2015 reform, access to debt adjustment for unemployed persons was also facilitated.<sup>50</sup>

### The effects of debt adjustment in Finland

Valkama (2011) examines the effects of debt adjustment for private individuals who have completed a payment plan. The study is based on a questionnaire<sup>51</sup> for debtors who have completed debt adjustment. In addition, she uses credit default data from Suomen Asiakastieto's register. The study finds that a "fresh start" does not always occur immediately after the end of the payment plan but instead as much as 37% of debtors still have debt one year after completion of their payment plan. Furthermore, one in four debtors takes on a new loan after the end of the payment plan and after two years 15% of those who completed their payment plan have new payment defaults in the payment default register.

The study highlights debtors' lack of ability to repay. According to the study only a small share of debts are paid during a payment plan period. Only 57% of debtors made any payments to their creditors during their payment plan. The remainder of the debtors were unable to pay back anything. Many debtors also experienced difficulties in meeting their costs of living and most of them were not employed during their debt adjustment. Instead, their income came from different kinds of social benefits. Around one in five respondents to the questionnaire reported that they had debts outside of the payment plan. Despite the failings, Valkama concludes that debt adjustment has improved the economic situation of most debtors and that all in all it has had a positive impact on debtors' lives.

According to Valkama's study most debt problems are caused by changes in an individual's life. 40% of debtors reported unemployment as a main reason. Around 30% ran into difficulties because of the end of an entrepreneurship. Also, personal guarantee liabilities had driven 30% of debtors to insolvency.<sup>52</sup> One in five respondents considered that their debt problems had mainly been caused by their reckless activity. In contrast, many bankrupt households in the U.S., for example, cite variations in earnings, uninsured medical bills, divorce and unplanned children as a main cause for their insolvency (Livshits et al. 2007).

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<sup>47</sup> HE (83/2014) vp.

<sup>48</sup> Retrieved 28.5.2020 from [https://www.stat.fi/til/velj/index\\_en.html](https://www.stat.fi/til/velj/index_en.html)

<sup>49</sup> Retrieved 19.8.2020 from <https://maksukyvyttomyysrekisteri.om.fi/>

<sup>50</sup> HE (83/2014) vp.

<sup>51</sup> The questionnaire was carried out in June 2011.

<sup>52</sup> Tala and Mutttilainen reported similar results in a series of studies in the 1990s. E.g. Tala et al. 1994.

Based on Valkama's study, it seems that in Finland expense shocks are not a key reason for becoming insolvent. Instead, income shocks plunged most of the respondents into insolvency. In Finland, comprehensive social security covers many of the risks that U.S. households reported as main reasons for their insolvency. However, it seems that social security is not enough to cover all of the risks that Finnish households face: 40% of respondents in Valkama's study reported unemployment as the main reason for insolvency. Despite the unemployment benefits provided by the state, some debtors still become insolvent as a result of unemployment.

The studies examined in chapter 3 of this report indicate that a debtor may be incentivized to resign from her job if the wage garnishments in their debt payment plan are large enough. The DAA takes this into account and therefore debtors are prohibited from intentionally weaken their financial situation. This prevents a debtor from resigning from her job, for example. A debtor is also required to accept a better-paying job if given the opportunity. If a debtor violates this obligation the payment plan may be ordered to lapse.<sup>53</sup> However, the Finnish system does not seem to greatly encourage the unemployed to find employment during debt adjustment. For example, an additional payment obligation is applied if a debtor's annual net earnings increase by more than EUR 2000. In that case a debtor may keep half of her additional net income in excess of EUR 2000 a year.<sup>54</sup> On the other hand, the Finnish enforcement system encourages unemployed debtors to find employment by allowing a debtor to have garnishment-free months if she finds employment.<sup>55</sup> No empirical evidence exists regarding the employment effects of these incentives. All in all, it would be important to investigate best practices to improve the employment level of insolvent individuals.

## Treatment of over-indebted entrepreneurs in Finland

### The amendment of 2015

Since 2015, private entrepreneurs have been able to discharge their business as well as their private debts under the debt adjustment process of the DAA and to continue their business activities.<sup>56</sup> Before 2015, business debts were treated only under the Restructuring of Enterprises Act<sup>57</sup> and the Bankruptcy Act<sup>58</sup>. The 2015 amendment was brought in because there was a lack of suitable insolvency procedures for private entrepreneurs.

In Finland, bankruptcy is followed by the liquidation of a debtor's assets but does not grant the debtor discharge, and for that reason many individual debtors who file for bankruptcy apply for debt adjustment

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<sup>53</sup> HE (180/1996) vp, s. 46.

<sup>54</sup> DAA Section 35a.

<sup>55</sup> EC Section 51a.

<sup>56</sup> DAA Section 45.

<sup>57</sup> Restructuring of Enterprises Act (47/1993).

<sup>58</sup> Bankruptcy Act (120/2004).

later. According to the Bankruptcy Ombudsman, who was interviewed for this study, around 10% of all bankruptcies are filed by natural persons. On the other hand, business restructuring can be an overly cumbersome procedure especially if the business activities are only small-scale. For that reason, it was seen as necessary to develop a mechanism which resembles business restructuring but also makes it possible to adjust the debts of a viable firm along with private debts.

However, an entrepreneur debtor must still fulfill certain conditions to receive debt adjustment. For example, her business activities must be reasonably small-scale and profitable enough so that the business's costs can continue to be met. In addition, it is necessary for the debtor to be able to pay at least part of her debts to her creditors. The Act on the Adjustment of the Debts of a Private Individual does not cover business activities under different company forms such as partnerships or limited companies<sup>59</sup>; it is rather directed at entrepreneurs whose situation is similar to wage earners.

The main idea of this legislation is that businesses can survive through the debt adjustment process and the entrepreneur can continue business activities as before the debt adjustment. Thus, the business must be profitable after the operating costs of the business and the living costs of the debtor and her family have been accounted for. According to interviews in the study by Niemi (2021), the business profitability is the most common impediment to the confirmation of a payment plan. The other main barrier to being admitted to the debt adjustment process as an entrepreneur is the requirement of bankruptcy comparison. This means that a court may not confirm debt adjustment if bankruptcy leads to a better outcome for creditors. This has caused trouble for debtors whose business activity is capital-intensive, such as farmers or road construction entrepreneurs (Niemi 2021.)

For a private entrepreneur, debt adjustment is a less costly and easier way to be relieved from debts than debt restructuring. In debt adjustment, the entrepreneur pays the trustee fee and also the fees of financial experts. The trustee fee is paid as a first priority during the first six months of the payment plan.<sup>60</sup> Otherwise the rules of the payment plan are the same for entrepreneurs as for other debtors. The duration of the plan is normally three years, and six months at most can be added in order to pay the trustee fee. If the debtor is able to keep her residence, the payment plan is prolonged. (Niemi 2021.)

### Small business bankruptcy

Personal bankruptcy enters the discussion occasionally. On May 2020, Ruut Sjöblom MP submitted a proposal<sup>61</sup> for a reform of the Bankruptcy Act which would make personal bankruptcy possible for

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<sup>59</sup> DAA Section 45a.

<sup>60</sup> DAA Section 30.

<sup>61</sup> The proposal has been signed by a total of 24 MPs.

entrepreneurs.<sup>62</sup> She was interviewed for this report about the background to the proposal. In her opinion, heavy debt burdens cause many negative effects for bankrupt entrepreneurs, and in extreme cases can lead to social exclusion. For that reason, it would be important for entrepreneurs to get quick relief from their debts through bankruptcy and make a fresh start.

In her view neither the existing bankruptcy law nor the debt adjustment of a private individual is adequate to help bankrupt entrepreneurs. This is because bankruptcy does not remove the debtor's obligation to repay debts that are not paid from the bankruptcy estate. In practice, this continuance of liability for debts affects only natural persons, because corporate debtors generally dissolve after bankruptcy. Also, personal guarantees can cause business debt liabilities for an entrepreneur after bankruptcy.

It is possible to adjust remaining business debts under the DAA after bankruptcy. However, strict requirements on the debtor often prevent admission to this procedure. For example, without employment or regular income, admission to debt adjustment may be difficult. Ruut Sjöblom highlights that it is usually impossible to start a new business if unpaid debts remain following bankruptcy. It can also be difficult for a bankrupt entrepreneur to find new employment.

In January 2020, the Ministry of Justice appointed a committee to prepare changes required by the EU Directive on Preventive Restructuring. The committee is also tasked with preparing necessary changes to the Act on Debt Restructuring and the Act on Adjustment of the Debts of a Private Individual in order to implement the objectives of the government programme. One of the purposes of the law reform is that entrepreneurs could make a fresh start faster than before. For example, admission to debt adjustment would commence faster for bankrupt entrepreneurs. The committee's term of office ends in spring 2021.

### Expert interviews

Three experts in enterprise insolvency were interviewed for this report: the judge of the district court of Southwest Finland, the Bankruptcy Ombudsman and the head of legal affairs of the Federation of Finnish Enterprises. They were asked how the 2015 amendment has affected the activity of the institution or organization they represent. They were also asked how frequently the procedure designed for entrepreneurs is used and what kind of weaknesses or problems have been identified in respect of it. There was also a question on counseling services for entrepreneurs.

It emerged that very few entrepreneurs have applied for debt adjustment in recent years. This is borne out by data from the Finnish insolvency register<sup>63</sup>. According to the register there were only 12 such cases in 2018

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<sup>62</sup> LA (15/2020) vp.

<sup>63</sup> See: <https://maksukyvyttomyysrekisteri.om.fi/>

and 13 cases in 2019. In contrast, according to the district court judge interviewed for this report, there were 12 to 15 cases in the district court of Southwest Finland alone in the first year following the 2015 amendment.

The small number of applications was unexpected. According to the district court judge, it was expected that there would be up to hundreds of applications each year. The head of legal affairs interviewed considered the system unsuccessful because of the unexpectedly low use. The Bankruptcy Ombudsman, however, stressed that the law was drafted in a very strict way and was never intended to be widely used.

According to the district court judge and the head of legal affairs at the Federation of Finnish Enterprises, one reason for the modest use of the procedure might be a lack of information regarding the options open to insolvent entrepreneurs. There have been a couple cases at the district court of Southwest Finland where a debtor applied for debt restructuring even though she would also have fulfilled conditions for debt adjustment. Generally, debt adjustment is much less costly compared to debt restructuring. Thus, it is plausible that at least some entrepreneurs who apply for debt restructuring would be better off applying for debt adjustment instead.

The district court judge considered it important to actively inform entrepreneurs about the various options available. If debt problems appear, the possibility to apply for debt adjustment should be made clear. It has also been questioned whether the debt adjustment procedure is overly cumbersome, but the judge did not consider this a plausible reason for the low uptake.

Because the choice between debt adjustment and debt restructuring is seen as a problem in the current system, it would be important for entrepreneurs with debt problems to seek help from finance and debt counselors, who are able to carefully investigate the situation of each individual. They ought to have the expertise to decide which process best fits in a certain situation. Finance and debt counselors can also redirect the most challenging cases to lawyers specialized in insolvency law.

One of the problems that the head of legal affairs pointed out in the interview is that entrepreneurs find their way to insolvency proceedings very late. When the business is already near bankruptcy, the business is unlikely to survive debt adjustment or debt restructuring, and thus the only remaining possibility is to file for bankruptcy.

Even though the number of applications has been unexpectedly low, the number of potential applicants is high. For example, 71% of all enterprises in Finland are small entrepreneurs and 220,000 are private entrepreneurs. Although the number of applications seems to indicate that debt adjustment affects a marginal population only, in fact over 200,000 individuals could potentially seek help from debt adjustment if debt problems arise. However, only private entrepreneurs fulfill the terms of debt adjustment and can apply for it. The head of legal affairs interviewed considers that one of the most important problems in the

current system to be that many small entrepreneurs conduct business as limited liability companies and are therefore unable to adjust their business debts under debt adjustment.

Enterprise Finland's Talousapu counseling service offers help and advice for entrepreneurs with financial and solvency problems. They receive around 2000 calls a year and less than 10% of those are directly related to debt adjustment issues. During the phone call the counselor evaluates the profitability of the firm and assesses if the entrepreneur fulfills the requirements to be eligible for debt adjustment. If the counselor assesses that the entrepreneur can apply for debt adjustment, a preliminary statement is given during the phone call. Only around 10 such statements are given per year. When an entrepreneur has received a preliminary statement, she can seek further help from a finance and debt counselor.<sup>64</sup>

## 5. Characteristics of insolvent households in Finland

This chapter looks at different measures of over-indebtedness. Insolvencies of natural persons in Finland are also examined in the light of statistics.

### Measuring over-indebtedness

Households need debt to finance their most expensive purchases, such as a house or a car. In economics, debt is also seen as a way to smooth one's consumption path over the life cycle. Nowadays, however, consumption is financed more and more with credit (Hiilamo 2018, 6). This growing debt burden naturally increases the amount of consumer defaults (Narajabad 2012).

There is no particular measure or definition of consumer over-indebtedness, rather understanding of the problem is largely based on different statistical indicators. These are usually based on the gross stock of household debt, net household liabilities, the capacity to service or repay debt or the sustainability of consumption behavior. (Betti et al. 2007, 137.)

Hiilamo (2018, 11-12) offers two measures for the risk of over-indebtedness: a debt-to-asset ratio over 75% and a debt-to-income ratio over three. D'Alesso and Iezzi (2013, 7-8) list common indicators of over-indebtedness, namely: high repayments relative to income, payments in arrears, heavy use of credit and seeing debt as a burden. On the other hand, the CPEC study (2013) suggests a broader measure where over-indebted households are those with continuous trouble in meeting their liabilities. Over-indebtedness can also be viewed from an administrative perspective in which the definition covers cases where a debtor's inability to pay debt has been officially registered (Betti et al. 2001, 40).

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<sup>64</sup> This information is based on a telephone conversation with the development manager of the Enterprise Finland Talousapu counselling service, Jari Leskinen, on 13 August 2020.

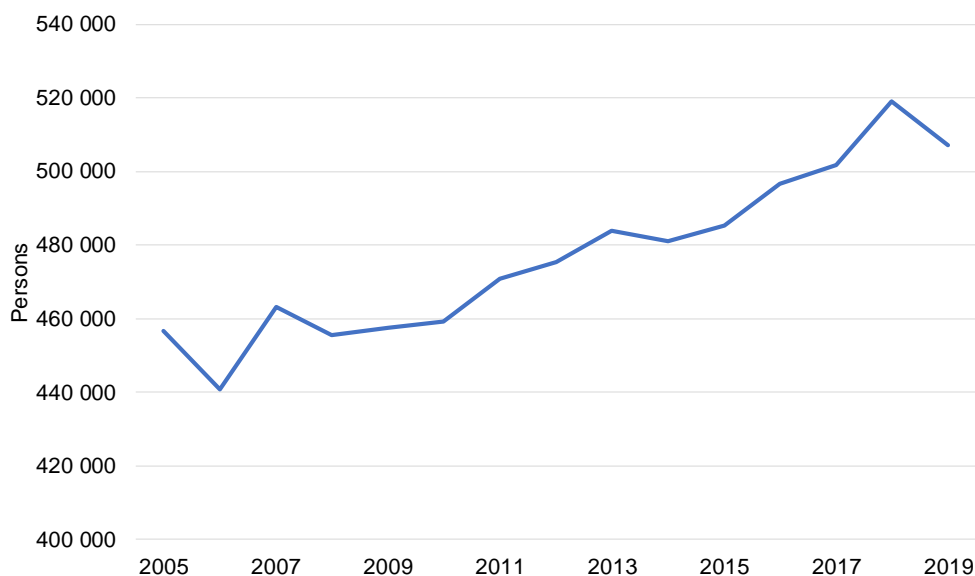


Clearly different indicators can classify different households as being over-indebted. It is also worth noting that not all over-indebted people are captured in the statistics as it is possible to avoid insolvency, for example with payday loans.

### *Enforcement*

Figure 1 shows that the number of debtors in enforcement has risen from 2005 to 2019, but there has been a small decrease following a peak in 2018. Nonetheless there were over 500,000 Finns in debt enforcement in 2019 and almost a fifth of them were in the second income decile. Around 50,000 debtors were in the first income decile.<sup>65</sup> Wages form only a small share of income for those who are in the bottom decile, but in the second decile the wage portion is significantly larger, which gives greater access to consumer credit.

*Figure 1: Debtors in enforcement in 2005-2019 (natural persons only).*



Source: Statistics Finland.

### *Debt adjustment*

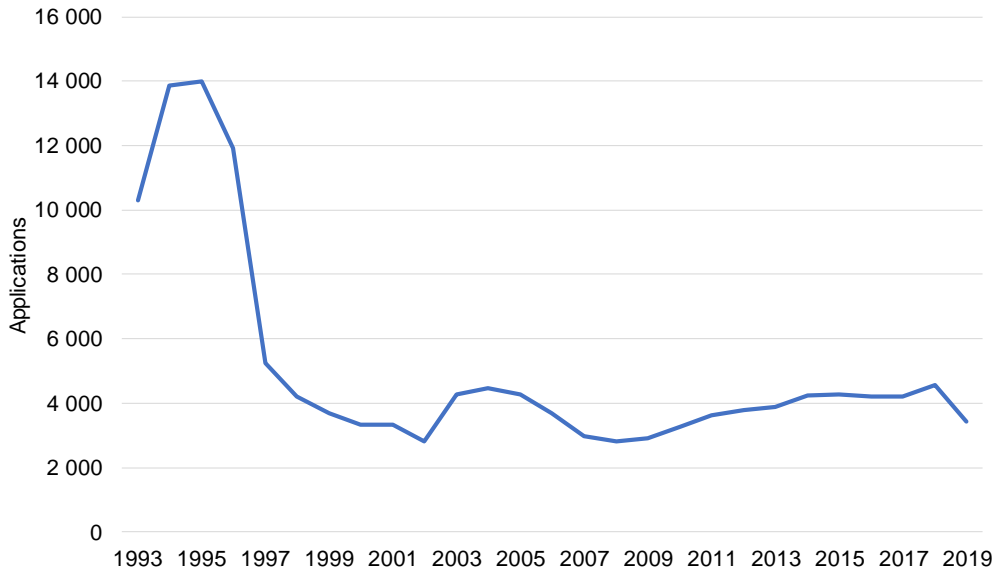
Figure 2 shows that applications for debt adjustment rose quickly after the introduction of the Act on the Adjustment of the Debts of a Private Individual in 1993. In total, over 137,000 applications had been made to district courts by the end of 2019. Nevertheless, the number of applications decreased towards the end of the 20<sup>th</sup> century and has remained stable since. In recent years, district courts have received around 4000 applications each year. Finance and debt counseling services were transferred from municipalities to

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<sup>65</sup> OSF: Enforcement: [https://www.stat.fi/til/uloa/index\\_en.html](https://www.stat.fi/til/uloa/index_en.html)

government legal aid offices in 2019, which slowed down the processing of applications and caused at least partly a decrease in the number of applications in that year.<sup>66</sup>

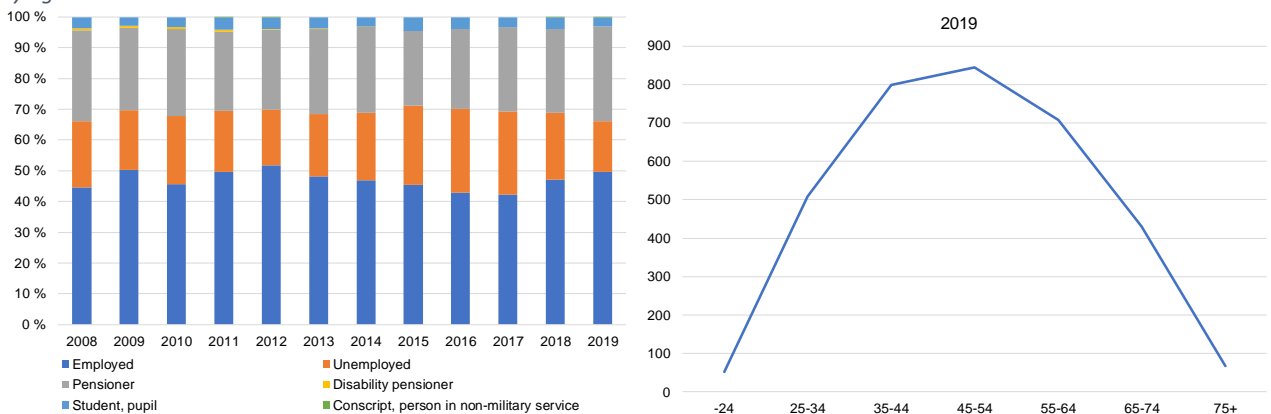
Figure 2: Applications for debt adjustment 1993-2019.



Source: Statistics Finland.

The left panel of figure 3 shows that around 47% of persons who have applied for debt adjustment in the past 11 years were employed. In contrast, around 49% of applicants were unemployed or pensioners.

Figure 3: Persons applying for restructuring of debts by main type of activity and persons applying for restructuring of debts in 2019 by age.



Source: Statistics Finland.

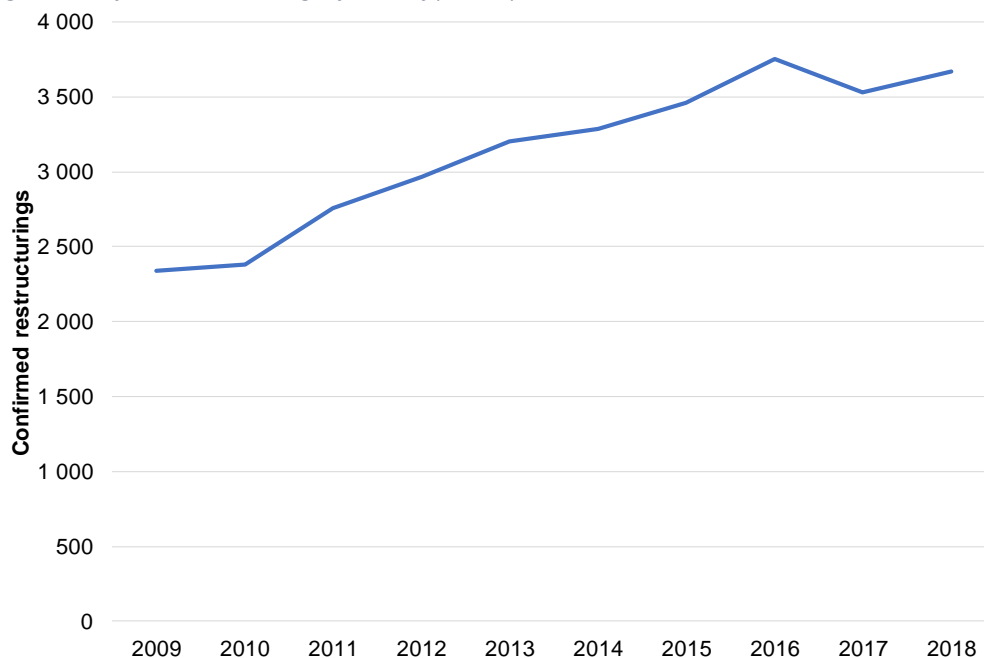
As seen in the right panel of figure 3, most applicants are middle-aged when applying. The figure also shows a hump-shaped pattern that is familiar from life-cycle income and consumption profiles. Figure 3 indicates

<sup>66</sup> [http://tilastokeskus.fi/til/velj/2020/01/velj\\_2020\\_01\\_2020-04-22\\_tie\\_001\\_fi.html](http://tilastokeskus.fi/til/velj/2020/01/velj_2020_01_2020-04-22_tie_001_fi.html)

that a fair number of pensioners have applied for debt adjustment but there have not been as many applicants over 65 years old. This could be interpreted as meaning that there are many pensioners under 65 years old among the applicants.

Figure 4 shows that the number of confirmed payment plans has increased after 2009. In the same period the law has been amended to improve access for entrepreneurs and the unemployed. In addition, in 2010 the duration of payment plans was reduced from five to three years. According to figure 2 and figure 4, the share of applications leading to a confirmed payment plan has been 80 to 90 percent of all applications during the observation period. The median debt of debtors received a confirmed payment plan in 2018 was EUR 39,000. This amount has increased slightly over the past ten years.<sup>67</sup>

Figure 4: Confirmed restructurings of debts of private persons 2009-2018.



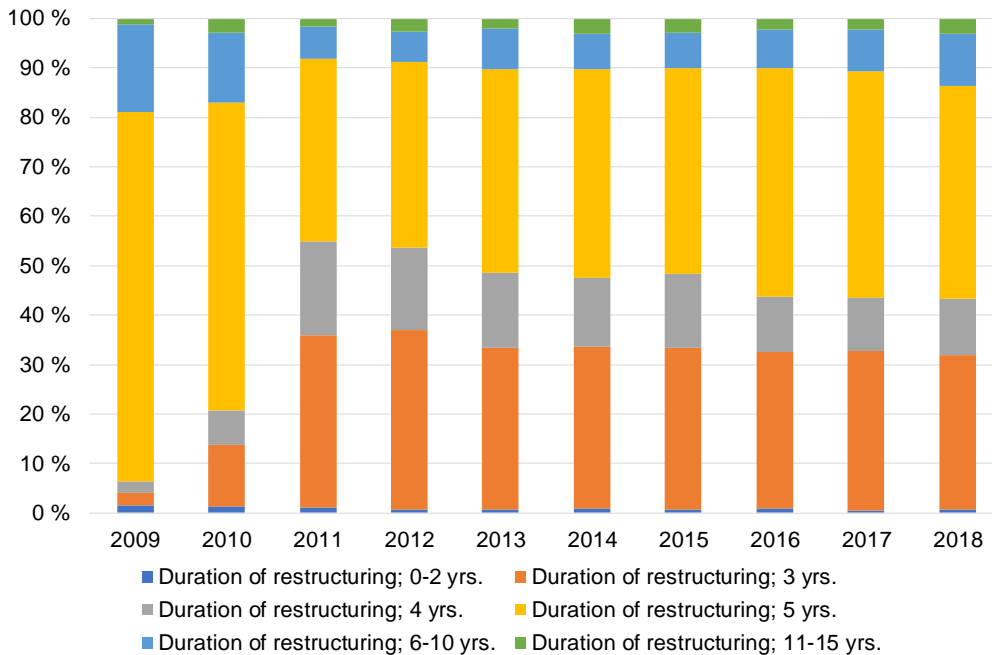
Source: Statistics Finland.

Figure 5 shows that after the reform in 2010, the number of three-year payment plans has increased, although five-year payment plans are still the most common. According to Section 31 a of the DAA, a payment plan can be prolonged by two years if the creditor is a private person. Five-year payment plans also applies to NINA debtors and debtors with a confirmed debt adjustment despite obstacles.<sup>68</sup>

<sup>67</sup> Official Statistics of Finland (OSF): Restructuring of debts [e-publication]. Helsinki: Statistics Finland [referred: 18.8.2020]. Access method: [http://www.stat.fi/til/velj/index\\_en.html](http://www.stat.fi/til/velj/index_en.html)

<sup>68</sup> DAA Section 10 a.

Figure 5: Duration of restructuring (only cases for which information is available).



Source: Statistics Finland.

### Insolvency register

The Finnish Insolvency register is a public register that includes insolvency information on business bankruptcies, restructurings and debt adjustments. There are 32 entrepreneurs' debt adjustment cases in total in the Finnish Insolvency register. The first registered case was initiated in August 2017. In most confirmed cases, applications are made by debt counselors and an administrator is appointed. In six cases, the duration of the payment plan is three years and is longer in the remaining cases. In three cases the duration of the payment plan is 10 years or more. In two cases the payment obligation is completely removed. In most cases, the entrepreneur's business activity continues despite the debt adjustment.<sup>69</sup>

## 6. Conclusion

This report discussed household over-indebtedness and insolvency issues. The report looked at what practices there are in other countries on insolvency of natural persons. The employment and welfare effects of different insolvency frameworks were also discussed. Details of the debt enforcement practices, social lending and debt adjustment processes in Finland were introduced. In addition, insolvency procedures for Finnish entrepreneurs were presented and problems in the current system were investigated through expert interviews. Statistics on over-indebtedness in Finland were also provided.

<sup>69</sup> Retrieved July 21, 2020, from <https://maksukyvyttomyysrekisteri.om.fi/>

Economic studies on insolvency frameworks highlight that the results obtained are highly sensitive to the prevailing environment. For that reason, previous studies discussed in this report cannot be directly compared to the situation in Finland. More lenient bankruptcy law can be more suitable for the U.S. economy because the social security provided by the state is not as comprehensive as in the Nordic countries. When income or expense shocks occur there and cause insolvency, individuals can discharge heavy debt burdens and get a fresh start. On the other hand, in countries with lower idiosyncratic risk, stricter bankruptcy law is justified. This is because a welfare state bears many of the risks affecting households' finances. In addition, lenient bankruptcy law does not come without costs. Previous studies have emphasized the trade-off that policy makers face when designing bankruptcy legislation. Swift debt discharge makes consumption-smoothing across states of nature easier, but it can increase borrowing costs, which on the other hand makes it more difficult to smooth consumption over time.

In Germany, the time to debt discharge is one of the longest in Europe. A theoretical study of the optimal insolvency framework in Germany noted that the optimal system would include an even longer garnishment period than the one currently in effect. This result challenges the conversation about the alleviation of insolvency systems in Europe. According to the study, a longer garnishment period improves welfare because if the payment period is prolonged, the garnishment rate can be lowered. A lower garnishment rate would reduce the substitution effect, which would increase labor supply because leisure time becomes more expensive. On the other hand, a prolonged garnishment period increases the income effect, which also increases labor supply as poorer households tend to work more. If creditors under this system recover more of their claims than under the current system, it should reduce credit costs and improve credit access, contributing to increased total credit in the economy and improving welfare.

In Finland, the duration of the payment plan in debt adjustment is generally three years. In this respect, the Finnish system does not seem to be stricter than other European systems. In addition, in Finland private entrepreneurs can also adjust their business debts under the Act on the Adjustment of the Debts of a Private Individual.

In a Finnish debt adjustment procedure, a payment plan is drawn up for the debtor. The intention of the payment plan is that the debts will be paid but at the same time it protects reasonable standards of living for the debtor. Monthly payments are based on the debtor's available funds. In addition, the debtor is allowed to keep all her assets that are classified as basic necessities and there is even a possibility to retain the family's owner-occupied home.

There are strict preconditions for debtors to be accepted for debt adjustment in Finland. Debt and financial counselors act as so-called gatekeepers in the Finnish system, because they often determine if the debtor can apply for debt adjustment. Strict preconditions can reduce moral hazard and abuse on the part of the

debtors. In economic literature it is suggested that strict insolvency legislation should be combined with truth-in-lending rules to prevent moral hazard on the part of creditors. For example, a positive credit record, which has gained some attention in Finland, would ensure that creditors have information about the debtor's financial situation. It could be used to encourage creditors to supply sustainable credit.

Based on debt enforcement and default statistics, it seems that there are large numbers of over-indebted people in Finland. However, very few of these people end up adjusting their debts in a debt adjustment procedure. In particular, the small number of entrepreneurs' debt adjustments has been unexpected. Based on this, it could be recommended that the availability of debt adjustment could be improved in the future.

In interviews with experts on enterprise insolvency issues, three problems regarding the current debt adjustment process arose: first, a lack of information about the possibility of debt adjustment. Second, often entrepreneurs seek help for debt problems too late. Third, only private entrepreneurs are allowed to discharge their business debts under debt adjustment and continue business activities.

This report concludes that the debt adjustment system in Finland could be more efficient, at least for entrepreneurs. In the current system, the situation of a bankrupt entrepreneur seems difficult. It would be important for over-indebted entrepreneurs to be able to receive a second chance faster than in the current system. It also seems that there are very few applications for debt adjustment in relation to the number of people in debt enforcement. The reasons for the relatively low uptake of the debt adjustment procedure should be further investigated in the future.

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